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New Section 403(b) Annuity Regulations: Nowhere to Hide

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The new Section 403(b) regulations provide the first set of comprehensive guidance on 403(b) deferred compensation arrangements in over 40 years. They are not effective until 2009, but tax-exempt entities that offer such arrangements need to understand and react to them before that date. The most important effect of these regulations is that the "plan" must be documented and that responsibility for administration be assumed by a party—most likely the employer. This will pose particular challenges for organizations that have merely supervised salary reduction elections but then have permitted employees to participate in a variety of 403(b) contracts with numerous service providers. It will be challenging to coordinate these policies or arrange for transfers, but some type of action may be needed before 2009.

Overview

Many tax-exempt organizations and local government entities like public schools have used special Section 403(b) arrangements sanctioned by the Internal Revenue Code to provide retirement income for their employees. These so-called Section 403(b) or tax-sheltered annuity contracts have rules that are similar to, but not the same as, 402(k) plans. They have less stringent nondiscrimination and reporting requirements. In 2004, the IRS issued proposed regulations that reflected updates

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for changes in the Internal Revenue Code and IRS guidance that have occurred over the past 40 years. These regulations explain:

- The requirement that a 403(b) arrangement generally be embodied in a written plan;
- Changes in the law reflecting maximum contribution limits, rollovers, plan distributions, and contract exchanges and transfers;
- Nondiscrimination requirements that apply to such contracts, including the so-called "universal availability requirement" that applies to salary deferrals under such plans;
- The rules for establishing who is the "employer" for purposes of nondiscrimination testing; and
- How Section 403(b) plans can be terminated.

In July 2007, the IRS finalized these regulations. The regulations are effective generally in 2009, but because they reflect many statutory changes that are effective now, some of the general rules recited in the regulations must be followed. (In essence, the new regulations reflect prior changes in the law.) There is a special 2010 effective date for certain church plans maintained by an organization that amends plans in connection with a church convention, and a special rule for government plans that are amended in legislative sessions. There are also certain rules, such as those governing transfers, that have separate effective dates, some of which have passed.

Evolution of 403(b) Arrangements

Some Section 403(b) arrangements operated without significant employer involvement. Many employers may have allowed employees to defer income under these arrangements, using the employer's payroll system, but the employer often allowed the employee to choose the funding contract from a variety of vendors. This was done in large part because the Labor Department regulations took the position that a 403(b) salary deferral plan was exempt from ERISA in cases of "limited employer involvement." However, as more and more distributions and other requirements began to apply to Section 403(b) arrangements, it became difficult to expect service providers to monitor such compliance, and in most cases, the service providers refused to accept such responsibility. The most significant feature of the Section 403(b) regulation is that it requires allocation and acceptance of compliance responsibility for the arrangements of all covered employees as a whole, and in most cases that responsibility will be given to the employer.

Employers with this responsibility will have to maintain a written plan that sets forth the 403(b) rules, coordinate the various vendors' contracts, and ensure that these rules are met. As with qualified plans, the IRS has now confirmed its position that a failure to operate or document a 403(b) arrangement affects not just the individual affected by the error, but disqualifies the entire arrangement.

The Written Plan and Plan Maintenance Requirements

Under the final regulations, a 403(b) arrangement must be maintained under a plan that has a written plan document, and must in form and operation comply with Section 403(b), as well as the governing documents. In most cases, even if the 403(b) plan is exempt from ERISA's reporting and disclosure requirements, it will need a written plan document. This formal rule generally goes into effect in 2009, although the IRS has maintained that some features of 403(b) arrangements, such as distribution rules, have to be set forth in some type of document currently. Quite often they are in addenda or are part of the vendor's contract.

Many 403(b) plans have some sort of written document that governs the entire arrangement. This is because a number of these plans are already subject to the ERISA requirement that a plan be in writing. Employers who make employer contributions to the plan (in contrast to merely authorizing salary reduction contributions) usually take the position that they have established an ERISA plan and are not able to take advantage of the narrow ERISA exemption for 403(b) salary reduction type plans. But after 2008, the written plan requirement will apply to all 403(b) plans, including those salary-reduction-only arrangements exempt from ERISA.

The written document will have to set forth how the plan will operate, and will have to contain, at a minimum, general information on the following:

- Eligibility rules, including rules showing compliance with the "universal availability" requirement for salary deferrals, discussed below;

- Plan rules for the timing and amount of contributions;

- Overall limits on contributions, including plan limits, and statutory limits under IRC Sections 402(g), 403(b), 415 and 401(a)(17);

- Distribution rules, including hardship distributions, if any;

- Beneficiary designations (which must comply with ERISA if the plan is an ERISA plan);

- Rollover rules;
- Rules for investment changes and transfers;
- Designation of responsible parties; and
- Processes for terminating and modifying the arrangement.

The regulations make it clear that a plan can consist of more than one document (for example, different contracts from insurance companies or mutual funds), but the employer is responsible for making sure that the documents are coordinated and do not contradict one another, and that the arrangement follows the document in form and operation.

Because the written document requirement is more extensive than in the past, and because the IRS now takes the position that the failure to have a proper document will destroy the tax benefits of the program, many 403(b) sponsors may ask whether they can have their document reviewed and approved by the IRS, as is the case with qualified retirement plans of taxable employers. Some 403(b) plan sponsors had, in the past, obtained a private letter ruling from the IRS that their document met the tax requirements of Section 403(b), although this is not required.

In Revenue Procedure 2007-71, the IRS provides a model 403(b) document for public schools. It states that if a public school employer amends its plan language to use the model language, the form of the written plan will be treated as meeting the requirements of Section 403(b), but only if the employer adopts the model language on a word-for-word basis or adopts an amendment that is substantially similar to the model in all material respects. The model language only reflects a basic plan that is limited to pre-tax employee deferrals; it does not have provisions for designated Roth, employer matching, or other employer nonelective contributions. An eligible employer that is not a public school may use the model language as sample language, but it will not have the same protective effect as use of such language by a public school. However, the IRS did state that if employers with a private letter ruling adopted provisions of the model language, those amendments would not results in the loss of the reliance on the private letter ruling for periods before the effective date of the 2007 regulations.

The regulations are not specific, but it seems clear from certain provisions in the regulations that the *employer* has to adopt the plan. The purpose of the rule is to ensure that some entity (other than the individual) is monitoring the arrangements for compliance with ever-changing IRS rules.

Many commentators observed that if, under the 403(b) tax rules, an employer must establish a written plan, ensure that all governing plan documents are consistent, and make sure that the arrangement in operation follows the documents, the employer's involvement would be more than "minimal." As a result, they expressed concern that the employer might not be eligible for the special ERISA safe harbor exception for "voluntary salary-deferral-only 403(b) plans with limited employer involvement" set forth in the Labor Department regulations at 29 C.F.R. Section 2510.3-2(f). As a consequence of ongoing discussions on this issue between the Treasury and the Labor Department (which enforces ERISA), the US Department of Labor (DOL) has issued a Field Assistance Bulletin, FAB No. 2007-02, explaining its position.

In FAB No. 2007-02, the DOL stated its view that an employer can in some cases meet the new 403(b) "plan maintenance" requirement consistent with the limited involvement safe harbor exception from ERISA. The DOL said that an employer that arranges for governing documents consisting largely of separate contracts and documents supplied by annuity providers, conducts periodic reviews of program operations, and even submits the program for corrections under the IRS correction procedure, could still meet the safe harbor as long as its other activities were minimal. But the FAB also states that the employer could not, consistent with the safe harbor, have responsibility for, or make, discretionary determinations in administering the program, such as authorizing plan-to-plan transfers, processing distributions, satisfying any applicable joint and survivor annuity requirements, and in making hardship, QDRO, and loan determinations. As a practical matter, it may be hard for an employer to bring its arrangements into compliance with Section 403(b) without this type of involvement. It also seems that the "separate contract" requirement runs counter to the goal of encouraging employers to adopt a program that they can operate on a consistent basis.

All employers that sponsor salary-deferral-only 403(b) plans and that believe they are exempt from ERISA pursuant to the safe harbor should review this FAB carefully. It is at the DOL Web site at *http://www.dol.gov/ebsa/regs/fab2007-02.* It is a good summary of what types of activities the DOL believes are and are not eligible for this limited safe harbor.

Special Rules for Church Plans

A church can purchase a 403(b) annuity contract or custodial account just like any other tax-exempt entity. Churches can also establish so-called 403(b)(9) retirement income accounts, which will be treated like 403(b) annuities. Under the final and proposed 403(b) regulations, a retirement income account is one that:

- Has separate accounting for the retirement income account's interest in underlying assets;
- Provides for investment performance based on gains and losses on those account assets; and

- Provides that the assets in the account cannot be used for or diverted to purposes other than the exclusive benefit of plan participants and beneficiaries.

Under the new regulations, a retirement income account must identify itself as such.[1]

Under the final regulations, a retirement income account must have a plan document and be maintained pursuant to a plan.[2] A plan must meet the applicable Section 403(b) requirements in both form and operation.[3] The regulations are not as clear as to whether annuity contracts contributed to by a church must meet the "plan maintenance" requirement. The author understands, however, that the IRS may be reconsidering the language in the 403(b) regulations and may limit this exemption further.

Note that church plan arrangements still have to meet contribution and distribution requirements, as well as minimum distribution limits, similar to IRAs. An employer that is concerned about its employees should question any 403(b) provider as to whether the contract has such limits and who enforces them. It should also make sure that the special rules applicable to church plans are in the contract and understood by the vendor.

Transitioning to the Plan Maintenance Requirement

The requirement that a 403(b) contract must be maintained pursuant to a plan applies to all plans unless specifically exempted, such as a church plan. The regulations allowed some such plans to be transferred on or before September 24, 2007, to another plan, but if that did not occur, existing 403(b) arrangements will have to meet new transfer requirements that are more stringent, as discussed below. This may pose challenges for employers.

Many financial institutions have refused to take on actual responsibility for "sponsoring" or supervising plans, although they have often provided the administrative backup to do so. Employers will also face challenges in transitioning to a "qualified" arrangement because financial institutions that now have 403(b) plans often impose heavy charges for transfers to another provider. These entities also take the position that an employer cannot "force" an employee to surrender the 403(b) contract and roll the proceeds to another institution. On the other hand, the employer has the responsibility to "maintain" a qualified arrangement—difficult to do if it cannot control the service provider. In other cases, the employer has ceased to exist or no longer sponsors a 403(b) plan. The IRS seemed to believe that the financial institutions offering the plans would maintain the plans and meet these requirements, but that is likely to be unrealistic.

The 403(b) regulations are generally effective in 2009. But rules allowing more flexible transfers became obsolete after September 24, 2007.

Transfers Within One Plan

Many times an employer may want to change or allow employees to change the vendor or investment product for its 403(b) plan. Under the new regulations, contracts that are part of a single plan can be exchanged for another contract, but only if it is permitted by the plan and if:

- The distribution restrictions in the new contract are not less stringent than those imposed on the contract that is exchanged;
- The participant's benefit is not decreased as a result of the exchange; and
- The employer enters into an agreement with the issuer of the new contract under which the employer and issuer will provide one another with information about the participant's employment, other 403(b) plans, and loans or other tax-related issues.

403(b) Transfers to Another "Plan"

The new regulations have stricter rules for transfers between 403(b) plans. This is because the regulations have tried to eliminate the ability of employees to move 403(b) funds independently from one vendor to another. The IRS believes that this practice, which essentially treats 403(b) arrangements as individual plans of each employee, created a variety of small independent plans that were not monitored for compliance by either the employer or the vendors.

Under the new regulations, after September 2007, 403(b) transfers away from a "plan" maintained by a particular employer are limited to situations where the participant is an employee or former employee of the employer sponsoring the *receiving plan*. Both the transferor plan and the receiving plan must provide for the transfer. Presumably, the recipient employer will be deemed to be responsible for the transferred contract within the receiving plan. In addition, a participant's benefit cannot be decreased due to the transfer and the receiving plan must impose restrictions on distributions that are no less stringent than the original plan. Absent this exception, and one special rule for transfers of permissive service credits, an employee will generally not be able to use the transfer rules to transfer 403(b) funds outside of a particular plan.

Transfers Between a 403(b) and a 401(k) Plan

The new regulations prohibit *transfers* between 403(b) and 401(k) plans, but they do not prohibit *rollovers* between 403(b) and 401(k) plans. Rollovers are specifically allowed under the Internal Revenue Code. But remember, to have a rollover, a *distribution event* (*e.g.*, termination of service, etc.) is required. A participant cannot move money via a rollover without a distribution event.

403(b) Nondiscrimination Rules

Section 403(b) salary deferral plans are subject to the so-called "universal availability" rule that requires an employer to offer all employees the right to elect salary deferrals. *Unlike 401(k) plans, employers cannot impose a one year waiting period for salary deferrals*. Certain employees can be excluded—non-resident aliens, work-study students, employees whose *normal* work week is less than 20 hours. The new regulations explain how tax-exempt entities define employer for this purpose. These rules have to be applied on a case-by-case basis and carefully reviewed. The IRS is aware that many employers have not followed the "universal availability" rule in the past, and looks for this issue in audits.

In past guidance, the IRS exempted certain additional categories of employees from the "universal availability" requirement—collectively bargained employees, visiting professors, certain government employees, or persons under a vow of poverty. These exclusions are *repealed*, thus requiring that these individuals be given the ability to defer their salary, although there is some transition relief.

In addition, employers who offer a match or other employer contributions are subject to objective nondiscrimination rules similar to those that apply for so-called "non-elective" contributions in 401(k) or profit-sharing plans. This requirement applies currently.

In connection with the new Section 403(b) regulations, the IRS issued new regulations under IRC Section 414 to expand on the definition of "employer" treated a single employer in the context of tax-exempt entities. The regulations adopt a prior standard used by the IRS in letter rulings—that 80 percent or more board control between two entities would create a single employer. The new regulations also have an optional rule that allows organizations to treat themselves as one employer if each of these organizations regularly coordinates its day-to-day exempt activities.[4]

Transitioning Old Contracts to the New Requirements

Many employers have 403(b) arrangements that include contracts that are no longer eligible for contributions but are still in existence and will be making payments (*e.g.*, former employees who have contracts with former vendors.) Where there is no current connection with the employer, it will be difficult for an employer to be able to maintain sufficient control over these contracts to ensure that all of the specific 403(b) requirements, including information sharing, and plan document maintenance and updating, are met. Revenue Procedure 2007-71 does provide some limited relief in this regard, for such contracts that were issued before 2009, if the employer makes a "reasonable good faith effort to include the contract as part of its plan." This effort includes collecting available information about the contract issuers and notifying them of the name and contract information for the persons in charge of administering the employer's plan. Other good faith actions described in the notice are having the issuer make efforts to contact the employer before making loans or distributions; it remains to be seen whether issuers will do that. There is also some limited transition relief for interim contract transfers between September 24, 2007 and 2009.

Terminating a 403(b) Plan

Prior to the regulations, the only way an employer could cease operation of a 403(b) plan was to "freeze" the plan by ceasing contributions to the plan. The employer could not terminate the contracts as they were between the employee and the financial institution. Under the new regulations, the employer can terminate a plan if the employer eliminates future contributions for existing 403(b) plan participants or limits participation to existing participants.[5] Benefits from the plan must be distributed as soon as practicable after termination. The regulations make clear that distributions of individual contracts are considered distributions for this purpose. A distribution of benefits upon termination is permitted only if the employer does not contribute to another 403(b) plan for 12 months. The plan document must provide for a termination process and distribution upon termination.

Generally, the Internal Revenue Code requires full vesting upon plan termination of pension plans or upon the cessation of contributions to profit sharing plans. This requirement is not specifically stated for 403(b) plans, but could be needed as a practical matter for employer contributions or matches.

A termination followed by a rollover may not accomplish all of an employer's goals if it wishes to establish a brand new 401(k) plan and force transfers of current 403(b) balances to that plan. Rather, it appears that upon a plan termination, the employer must distribute all plan assets, but the employer cannot force its employees to roll over their distributions to the new 401(k) plan.

Conclusion

Prior to the issuance of the proposed and final regulations, employers and financial institutions often took the position that either the other entity—or the employees themselves—were responsible for monitoring 403(b) compliance. In essence, these entities looked to someone else to operate the program. The IRS regulations make it clear that if a 403(b) program exists, someone has to sponsor it. The employer can no longer hide behind the service provider or employee. There is nowhere to hide. These ever-complex rules must be documented and obeyed.

Some hope that the financial institutions offering these plans will step up to meet the IRS requirements. It is more likely that some institutions will stop offering these plans, and that only those institutions willing to help employers meet the new rules will remain in the business. Although the new regulations are not effective until 2009, it is anticipated that the 2008 year will be one in which the IRS and sponsoring employees struggle to find a middle-ground that allows these arrangements to continue.

Employers with Section 403(b) arrangements should work with service providers to meet these new rules, and they should not allow themselves to be bullied into accepting explanations from service providers that "this is how it is always done." The 403(b) regulations make it clear that the rules have changed.

Notes

1. *See* Treas. Reg. § 1.403(b)-9(a)(2).

2. *See* Treas. Reg. § 1.403(b)-9(a)(2)(ii).

3. *See* Treas. Reg. § 1.403(b)-3(b).

4. *See* Treas. Reg. § 1.414(c)-5.

5. *See* Treas. Reg. § 1.403(b)-10.

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